SGH20 Insights

UK TRAVEL DIARY - JUST ABOUT MANAGING

"There is nothing wrong with change, if it is in the right direction" Winston Churchill

In the wake of the Brexit vote, and given our portfolio exposures to the UK and Europe, we recently undertook a research trip to the UK in November-December to assess first hand the mood and implications.

Whilst we spent much of our time in London, having lived there for 5-years, we are all too conscious it is not representative of the 72% of the population who turned out to vote, and nearly 52% who voted to leave the EU. We ventured to Scotland and met with a number of businesses located in Northern England, as well as on the continent across a broad range of sectors including banks, wealth management, retail, infrastructure, real estate, transport, healthcare and paper and packaging. This included companies we are invested in, as well as competitors and customers in the unlisted and listed arena, and regulators and policy advisors.

Brexit Observations

- There was no shortage of reasons as to why Brexit happened. Everyone we spoke to seemed to have their own anecdote to tell, and opinion varied widely as to what the main causes of the 'yes' vote were. Our assessment is it was rooted in:

    - An unnecessary referendum for short-term political gain by Prime Minister Cameron.

    - Growing income inequality and rise of the JAMs - the new acronym for the trip! JAMs are the disenfranchised middle class who are struggling to get by and 'Just About Managing' – the main stayers of the vote to exit the EU. They have failed to benefit to the same degree as low income households from the welfare system, are being squeezed by rising property prices, low wage growth and not participated in the financial asset boom. They are the cohort who is struggling to keep up and feel left behind by globalisation. Most own their home, but worry a bout paying a mortgage and the cost of living and getting their kids into a good school. More than two thirds have l ess than a month's incomes worth of savings[1].

    - Domestic policy failures & immigration: Since the enlargement of the EU in 2004 and accession of seven of the former 'Eastern bloc' countries (including Poland, Hungary, Czech Republic, Cyprus) immigration into the UK has accelerated, and the influx of unskilled and blue collar labour, particularly in the service and building and construction sectors, has given rise to anti immigration sentiment and growing concerns around immigrants taking local jobs and grafting off the welfare system. When combined with the steady increase in income inequality, declining real wages, and failure of government policy around affordable housing (with housing demand out pacing construction, for 35 years) and financing of public services (principally schools and health), this appears to have weakened social cohesion and lead to high levels of dissatisfaction.

    - The UK press. It is often said newspapers no longer matter. But UK editors of the larger circulation papers mounted a fevered pitch to exit, which in a close call was arguably influential, and at times misleading. When The Sun exclaimed in a headline "Queen backs Brexit" it was cause for the Independent Press Standards Board to step in. Loughborough University's Center for Research in Communication calculated 82% of newspaper articles about the referendum favoured Brexit.

- The almost universal response from those we met was the economy, post Brexit, is proving more resilient than expected, confounding the early economic forecasts and political rhetoric. After the initial shock it's largely business as usual so far, with strong consumer spending and growth in services offsetting weaker investment intentions.

- Despite this, there remains a strong air of caution and uncertainty with a common feeling this is the twilight zone ahead of Article 50 being triggered. Fear exists a 'hard' Brexit will see an increase in domestic political instability, and some significant challenges. The risk is a full exit from the customs union would be highly disruptive economically and compromise investment in major UK export sectors such as automotive manufacturing, not to mention the import dependent sectors across many European countries. But, there was also a strong sense pragmatism will prevail and trade will continue given the established supply chains and trade flows around areas of relative competitive advantage. Southern Europe is the food bowl for much of Northern Europe including the UK, who remain heavily dependent on German manufactured goods.

- The sharp devaluation in the pound is already feeding through into import inflation. The risk is this could see a slowing in consumer growth, which has been the key driver of the UK's resilience since the referendum. Interestingly, Brambles' noted customers are already seeking new ways to partner with suppliers to lower costs as they seek to manage price rises. The decline i n the pound is also attracting investment. Foxtons and Lendlease both highlighted a pick-up in interest from foreign p roperty investors with a longer term view. Nissan's announcement in October to keep open and expand its Sunderland p lant, after receiving Government a ssurance they will compensate for any tariff imposed from revised trade a greements, was also a topic of conversation. We expect the currency and more independent UK labour laws were also motivating reasons for Nissan's decision.
- Despite Brexit being a vote against immigration, a number of meetings highlighted concerns the UK would lose the benefits of European immigration, and consequently, the financial sector under changes to passporting and aspects of the Eurozone's financial infrastructure would shrink. Healthcare, construction and maintenance, and the service sector were areas sighted as potentially being most impacted by any changes to immigration rules.
- It is too early to say what the broader implications of Brexit are for Europe and the EU. Despite the noise we would be surprised if Scotland left the UK. Whilst the Scots are fiercely nationalist they are also thrifty, and the general view was they lack the fiscal independence. We note, the post Brexit vote spike in Scottish opinion polls to separate has now returned to a Unionist majority. The looming Dutch (Mar-17), French (Jun-17) and German (Oct-17) general elections are seen as critical in influencing the future direction of the EU and policies around inequality, immigration and trade. It remains to be seen whether the EU will stick to its official hard line response to the UK or cause consideration for reform.

Sector Observations & Talking Points

- **Housing**

  * The premium London housing market is very soft post Brexit, while nationally transactional volumes and prices continue to grow modestly. Foxtons, a premium London based realtor, indicated central London sales volumes are down 25-30% post Brexit. Nationally volumes are +2% yoy and average house prices increased +4% over the last 12 months. Rightmove, the leading online listing player, saw a double digit decline in listing volumes in Q3CY17 (-16%) on pcp immediately following Brexit, but suggested in Q4 listing volumes were better, down single digit on pcp.

  * Housing affordability remains a massive social issue, particularly in London. There is a strong focus by Government and local councils on regeneration projects and partnering with private companies to develop Private Rental Services (build to rent, not sale), which now represent 16.5% of all new housing developments in the UK. LLC is well placed to participate in this market and is currently bidding on three large regeneration schemes.

  * We have long thought the real estate commission pool in Australia is ripe for disruption. It appears this is happening in the UK. There are now seven UK online real estate agents including Purplebricks, which listed in Dec-15. No players are currently profitable, but c.5% of UK real estate volumes are now transacted by online agents based on a flat upfront fee which is typically only 10-15% of a traditional agents fee on success. Purplebricks announced i t entered the Australian market in Jul-16, and sees the Australian market as an attractive opportunity. We will wa tch with interest!

- **Financials**

  * Macro prudential measures and buy-to-let lending affordability measures in the UK have become increasingly restrictive. In Mar-16 stamp duty was increased 3% on second home purchases and affordability rules now require minimum interest cover of 145% (was 125%). For investors tax changes have seen the flat 10% 'wear and tear' allowance scrapped and from 2020 restrictions on tax deductibility of interest will apply for certain investors – is this a cautionary lead to negative gearing changes in Australia?

  * Before the launch of Metro bank in 2010 there were no new banking licences issued in the UK for over 100 years. Since 2008 there has been a steady stream of new applications, and 22 new banking licences issued. Most of the first wave banks sort to target niche markets and geographies. Now we are seeing a greater focus on business models based on digital technology and mobile apps. In April 2016 Atom Bank became the first app based bank to launch with fixed term savings and iphone accounts for ipad apps. In developed markets with high mobile

penetration (like Australia) we believe we will increasingly see challenger banks competing and collaborating with incumbent banks to improve the customer experience and lower operating costs.

* In aggregate the UK banks have paid out close to £50bn since 2006 in Payment Protection Insurance (PPI) misconduct claims to customers – in itself a mini fiscal stimulus program. To add some perspective, this is >3x the Australian Government's fiscal stimulus payouts to household in 2008-09!

- **Healthcare**

  * The UK now ranks 8th in the world in obesity, with 25% of adults clinically obese and 4.5m adults now with diabetes; an increase of around 1.5m since 2005. It adds to our longer term view that it is inevitable sugar taxes will become more universally imposed by Governments' as they seek to constrain health costs.

  * The National Health Service (NHS) budget is currently £117bn with 7.6% (£8.9bn) spent with independent private sector players (including hospitals), which is growing at 10% p.a (i.e £800m), 3-4x the rate of the total NHS budget. NHS bed and theatre use is already at c.95% and NHS trusts are increasingly reliant on the private sector to add capacity as they struggle to just meet wages and maintain their 18 week waiting list targets. The orthopaedic waiting list in Sep-16 stood at 500k, the longest waiting list for NHS treatments. This is providing a strong runaway of growth for private hospital operators (like Ramsay Healthcare and Shire).

  * UK Private Medical Insurance (PMI) coverage is 10-11% and declining, and unlikely to be helped by the 2% insurance levy increase (to 12%) announced in the Autumn Budget. Further, from Apr-17 employees lose the tax benefit on PMI if they take a policy individually and salary sacrifice. This is providing a strong incentive to have a company paid scheme and smarter companies are using this as a tool to attract staff.

- **Other**

  * Greater BT2B integration and customer collaboration is evolving as a focus as companies look for the next layer of cost savings and ways to increase customer retention. Brambles in Europe is working closer with customers using CHEP's buying power to procure logistics cheaper and tracking pallets through the supply chain. CHEP is trialling a beacon on pallets that sends active messages to retail customers' smart phones to advise them of promotions. In one case it doubled the sales on a fast moving consumer goods (FMCG) promotion; a surprise, which has encouraged them to do more work.

  * The digital marketplace for takeaway delivery is growing strongly. Takeaway in the UK is a £5.5bn market and growing at 20% p.a. driven by online ordering. We met with Just Eat, the largest listed UK online takeaway player, who acquired Menulog in Australia in May-16. Just Eat focus on the order aggregation for restaurants, but are starting to look at leveraging their scale by collaborating with food and restaurant suppliers to bulk buy staple products and pass on the savings to their restaurant customers – similar to the Domino's commissary model. Just Eat made the interesting point that they see little incremental competitive benefit in getting waiting times down below around 15-20 minutes. They say the key is delivering when you say you will, not delivering quicker beyond this point. We were left wondering how the growth in the digital takeaway marketplace and entrance of Just Eat, Deliveroo, Uber Eats and Amazon impacts the competitive positioning of Domino's Australia longer term.

Our Thoughts

- We came away with growing sense Brexit marks a journey into the unknown, for a country divided but not broken. The political rhetoric remains extremely cautious and significant uncertainty prevails. In most part, this seems to reflect a broader lack of leadership as a Government in turmoil is still trying to work through its Brexit strategy. Recent comments by Prime Minster for a 'clean' break provide more clarity to the UK's strategy, but we are still at the start of a long, bumpy and complicated process.
- After the initial shock it's largely business as usual. The risk is that the UK triggers Article 50 and seeks to renegotiate trade agreements and growth slows. There is a wide range of plausible outcomes for the UK economy, complicated by political uncertainty around elections in a number of key EU member states during 2017 which could make companies more cautious leading to a slowdown in investment, hiring and consumer growth. Our base case is the economy muddles through rather than enters a recession. The devaluation in the pound, accommodative BOE policy stance, potential for fiscal policy, and the fact London remains a vibrant global hub and city-state[2], remain insulating factors in our view. Google, Facebook and Apple's recent decisions to make London their European headquarters would seem to pay this testament.
- Longer term we see potential for a less London centric, more balanced economy, and with potentially better social policies, and more accommodative and flexible business legislation. The Autumn Budget Statement (UK equivalent of

our MYEFO), released whilst we were in the UK, included a number of fiscal measures appealing to the JAMs around affordable housing.

Portfolio Implications

- At a portfolio level we continue to remain comfortable with our position in Clydesdale Bank, and see the tenants of our thesis around, a strong cost out story; more regional focus; potential for capital release; and industry consolidation as still intact. About 10% of Lendlease's earnings are exposed to the UK and Europe. Over the medium and longer term it remains well positioned to participate in the regeneration and affordable housing projects in London, which if anything is now a higher priority for the Government in the wake of Brexit. A change in emphasis towards more build-to-let (rather than build-to-sell) model arguably also plays to Lendlease's integrated model with the potential to receive a development margin, funds management fee and asset management fee, but would likely be more capital intensive (and potentially lower returning depending on tax relief and fees earned). Brambles' European business seems to be tracking to plan, and they have a number of initiatives they are working on that provide us with confidence the European business should continue to grow even if UK economic growth slows somewhat.

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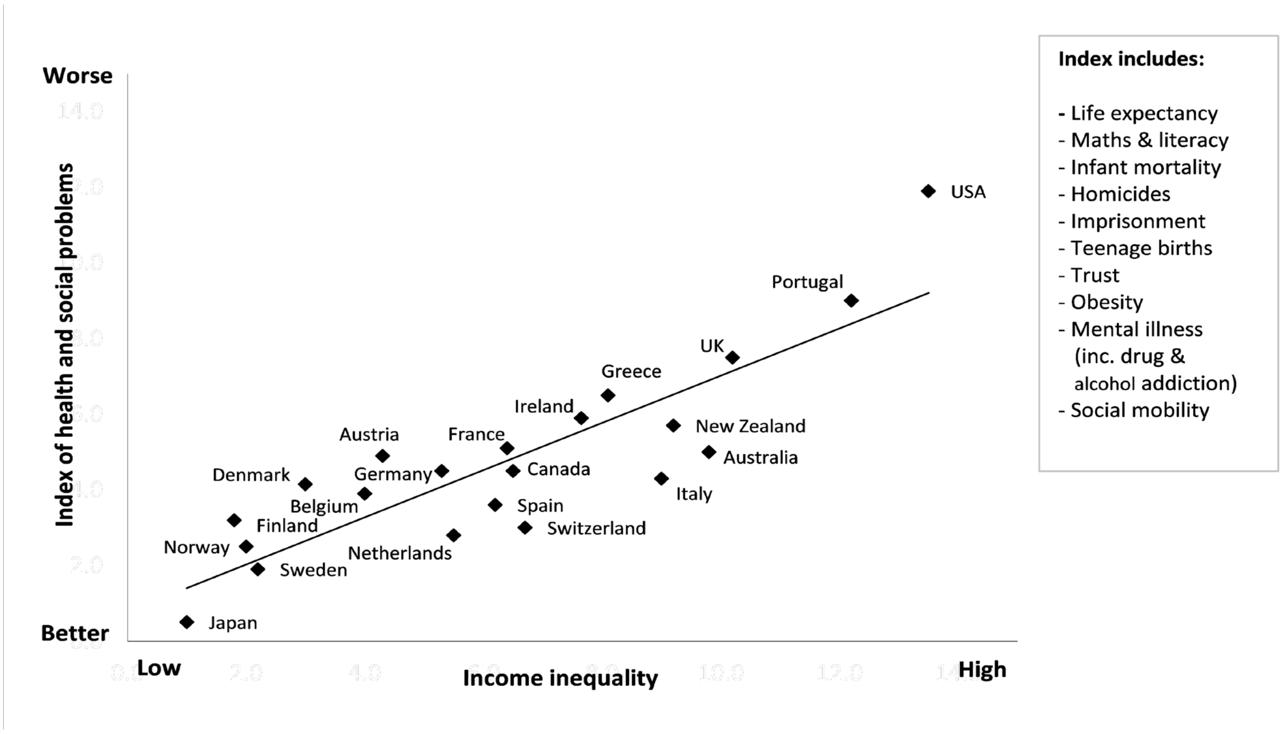
[1] Resolution Foundation, Analysis and action on living standards, September 2016.
[2] McKinsey & Company in "When cities rule the world" by Parag Khanna argue, very persuasively in our view, that in this century, it will be the city - not the state - that becomes the nexus of economic and political power, and already the world's most important cities (which includes London) generate their own wealth and shape national politics as much as the reverse. See http://www.mckinsey.com/global-themes/urbanization/when-cities-rule-the-world

A word on Social Cohesion and Inequality in Australia

Social Income and Inequality



Source: Wilkinson & Pickett, The Spirit Level (2009), Equality Trust

There is no straight answer to the forces that led to Brexit and Donald Trump's election. But in their wake, and given the rise of minor parties at the last Australian Federal election, we have been asked whether the issues which are seen as being at the core of the changes, income inequality and growing social tensions, could drive similar political and economic change in Australia. To our mind, there are important differences, and it would be overstating to say we are heading down a similar path. But we cannot be complacent. The lesson from Brexit and the US election is, all stakeholders in Australian society need to work hard to protect, preserve and enhance the Australian way of life and our standard of living.

The exhibit above [1] provides a useful reference in helping think about this, and the relativities of where Australia lies. It shows amongst developed world countries the US ranks dead last by some margin on both income equality and social cohesion. In the US the real hourly wage has remained essentially flat for the last 45 years, as the income of the top 1% has more than tripled, and taxes have not rebalanced this but actually changed to lower the relative burden on the well-off. Further, a long history of valuing freedom over fairness, enshrined in the Constitution and entrenched in the wide divisions and social inequity that exists across the country, sees a low level safety net and social services.

The UK ranks considerably ahead of the US on both measures, but in a relative sense still poorly and an outlier. Its long history of class hierarchy, colonialism and immigration have made social cohesion more difficult. This is despite a strong welfare culture rooted on voluntary provisions via churches, and mutual and friendly societies, and later the State, through the NHS and commitment to full employment in the post war period.

Australia ranks similar to the UK on income equality but on social cohesion (index of health of social issues) more in line with France and Canada. There is evidence to suggest income inequality is rising in Australia[2], and one can certainly point to areas of disadvantaged and worrying trends in inequality, and an increasingly disenfranchised middle class who are struggling to get by and 'Just about managing'. However, there are also material differences in living standards, the social contract and social services enshrined in statute and our values, and social cohesion which arguably separate us apart from the US and UK. This is reflected in a greater emphasis on fairness and protection of the vulnerable through the old age and disability pension, minimum wage and industrial relations system, and community support for these rights. In our view, it is also a result of Australia's multicultural success, based on accepting immigration as a national building project and public acceptance of cultural diversity.

[1] Thanks to Jeremy Grantham from The Spirit Level: Why Greater Equality makes Societies Stronger by Kate Pickett and Richard Wilkinson)

[2] Australian Council of Social Service, Inequality in Australia 2015